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MEMORANDUM

Arizona Corporation Commission

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FROM: Utilities Division

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AZ CORP COMMISSION
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DATE: June 29, 2001

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RE: WATER TASK FORCE OF THE ARIZONA CORPORATION COMMISSION
(DOCKET NO. W-00000C-98-0153)
(DECISION NO. 62993)

On November 3, 2000, the Commission issued Decision No. 62993. This decision approved Staff's recommendations regarding the Commission's Water Task Force. The Commission directed Staff to work with interested parties to develop policy statements, some of which are due by June 30, 2001. Staff has had a number of meetings with interested parties to discuss the issues and resolve parties' concerns on many occasions, as noted below. The reports addressing specific subjects reflect a consensus of the working groups. In only one working group did Staff disagree with a portion of the group's resolution of an issue, which is also discussed below. The reports address the following issues:

Finding of Fact No. 9 from Decision No. 62993 ordered Staff to develop a policy statement regarding Certificates of Convenience and Necessity for water systems. Attachment A to this memorandum is a proposal for this policy developed in a meeting with interested parties.

Finding of Fact No. 11 ordered Staff to develop a policy statement regarding acquisition adjustments and rate of return premiums for water systems. Attachment B to this memorandum is a proposal for this policy, which was developed based on several meetings with interested parties.

Finding of Fact No. 29 ordered Staff to develop a policy statement regarding tiered rates. Attachment C to this memorandum is Staff's proposal for this policy, which was developed after several meetings with interested parties.

Finding of Fact No. 31 ordered Staff to develop a policy statement regarding recovery of costs related to the Central Arizona Project. Attachment D is Staff's proposal for this policy, which was developed after several meetings with interested parties. Staff is in agreement with this proposal, except for the portion which deals with the definition of the term "use." The attached policy defines "use" as those methods considered as "use" by the Arizona Department of Water Resources (ADWR). The current regulations of ADWR allow a water company to be in compliance with its requirements as long as the water system uses its CAP water anywhere within the same Active Management Area (AMA) in which the water system is located. This approach is contrary to the position the Commission took in a recent Vail Water Company (Vail) rate case.

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In Decision No. 62450, the Commission approved Vail's cost recovery of its CAP costs with specific mandates regarding Vail's long-term plans for the CAP water. At present Vail is using its CAP water in an "in lieu recharge project". Vail's CAP water is being used by a farm in Red Rock in lieu of the farm using groundwater. Because the farm in Red Rock is in the same AMA (Tucson AMA) as Vail, Vail gets credit for this use by the farm and therefore, is in compliance with ADWR requirements, even though the farm is approximately 60 miles from Vail. Staff believes that the water being recharged in Red Rock will never actually directly benefit the aquifer in Vail and therefore, never benefit the customers of Vail. This was the basis for the Staff recommendations that were adopted by the Commission in Decision No. 62450. The Commission ordered Vail to submit, within 10 years of the Decision, a plan to use its CAP water directly in its certificated area. Decision No. 62450 also ordered Vail to actually begin using its CAP water within its certificated area within 15 years of the Decision.

For these reasons, Staff recommends that the Commission slightly, but significantly, modify the definition of "use" contained in Attachment D by adding the condition that the water system would have to use its CAP water within its certificated area.

Staff recommends that these policy statements be discussed at an Open Meeting at the Commission's convenience.

A handwritten signature in black ink, appearing to read "Deborah R. Scott". The signature is fluid and cursive, with the first name being the most prominent.

Deborah R. Scott
Director
Utilities Division

DRS:SMO:

ORIGINATOR: Steven M. Olea

ATTACHMENT A

Proposed Policy for Water Certificates of Convenience and Necessity

The Commission has established a policy goal of ensuring Arizona's water consumers are served by viable utilities. In Decision No. 62993, the Commission required Staff to develop a policy statement on Certificates of Convenience and Necessity (CC&N) for water systems which conforms to the general principles of Staff's recommendation as contained in the Water Task Force Report of October 28, 1999.

The Arizona Constitution, Article 15, Section 3, provides in part: "The corporation commission shall have full power to, and shall... make reasonable rules, regulations and orders, by which such corporations shall be governed in the transaction of business within the state.... Provided further that...rules, regulations, orders and forms...may from time to time be amended or repealed by such commission. "

State law on CC&Ns requires, in part, that a public service corporation shall not begin construction of any plant or system without first obtaining a CC&N from the Commission. (See A.R.S. 40-281) In processing a CC&N the Commission is performing a judicial function, (See A.R.S. 40-282), Staff, as a party to the case, is charged with developing, and making a recommendation on the application to develop the record for the hearing on which the Commissioners base their final decision.

The Arizona Administrative Code R14-2-402, Certificate of Convenience and Necessity for water utilities, is used by Staff to guide the development of their recommendation on the application. The rule requires the Applicant to provide the following information:

- a. Proper name and address of the utility and its owners,
- b. Articles of Incorporation and Corporate Bylaws,
- c. Type of plant and facilities to be constructed,
- d. Complete description of facilities to be constructed, with preliminary engineering specifications to describe the principle systems and components to meet the needs of the health department, and final engineering drawings when they are available.
- e. The proposed rates,
- f. Estimated total cost of the facilities,
- g. Manner of capitalization, method of financing the utility,
- h. Financial condition of Applicant,
- i. Estimated annual operating revenue and expenses from the proposed construction,
- j. Estimated starting and completion dates of the proposed construction,
- k. Maps of the proposed service area,
- l. Appropriate city, county and/or state agency approvals,
- m. Estimated number of customers to be served for each of the first 5 years of operation, including documentation to support estimates.

Staff also requires the Applicant to provide: the request for service initiating the "necessity" of the request for a CC&N, appropriate approvals from the Arizona Department of Water Resources (ADWR) and the Arizona Department of Environmental Quality (ADEQ), and compliance status information from the ADEQ and ADWR.

In order to assist the Commission in its goal to eliminate the proliferation of non-viable water systems, it is recommended that in addition the above, the following should be required:

1. Unless the Applicant is an existing public water utility in Arizona or is an affiliate of an Arizona public water utility, an Applicant for a new CC&N (i.e., not an extension to an existing CC&N) must demonstrate that existing water utilities have refused to extend their territories to include the requested area. This demonstration shall be made by the Applicant providing all the following:
 - a. A copy of the Applicant's request for service from all Class A* water utilities in the State as well as the refusal to serve from all those Class A water utilities, and
 - b. A copy of the Applicant's request for service from all or at least five (5), whichever is less, of the Class B* water utilities serving within fifty (50) miles of the Applicant's requested area as well as the refusal to serve from all those Class B water utilities, and
 - c. A copy of the Applicant's request for service from all water utilities* serving within five (5) miles of the Applicant's requested area as well as the refusal to serve from all those water utilities.

* Any utility willing to serve must respond to the Applicant within thirty (30) days of the Applicant's request and must meet item #3 below.
2. If the Applicant has received an affirmative response to a request for service within thirty (30) days of its request from any of the above water utilities, but believes that such service would not be cost-effective nor in the public interest, the Applicant shall submit detailed information and cost data that clearly and convincingly demonstrates such an opinion and that the granting of a CC&N to the Applicant is in the public interest.
3. The Applicant must demonstrate that it and all its affiliates and associated management or operations personnel are in compliance with all applicable Commission, ADEQ, and ADWR requirements. In the event, the utility, any affiliate, or associated management or operations personnel are not in compliance with Commission, ADEQ or ADWR requirements, the Applicant must demonstrate that the non-compliance is related to the recent acquisition or affiliation with a deficient utility. With regard to ADE, the Applicant shall be considered in compliance if it, or any of its affiliates, does not have or has not had within the 12 months prior to the application, any major deficiencies with regard to physical facilities, operation and maintenance requirements, or monitoring requirements.

4. Initial rates for a new CC&N should be designed such that the utility would have the opportunity to break even (zero percent rate of return) at the end of its third year of operation. These rates should also provide the utility the opportunity to earn a reasonable rate of return by the end of its fifth year of operation. Rate levels and the rate of return would be based on the Applicants reasonable projections of customer growth and the rate base required to properly and adequately serve the customers.
5. For new CC&Ns that are not being served by an existing utility, the following charges shall be set as follows:
 - a. Establishment (normal) -- \$20.00
 - b. Establishment (after hours) -- \$35.00
 - c. Reconnection -- \$20.00
 - d. Meter Test (if correct) -- \$25.00
 - e. Deposit -- 2 times the monthly minimum plus 15,000 gallons
 - f. NSF Check -- \$25.00
 - g. Service Call (after hours) -- \$40.00
 - h. Meter Re-read -- \$35.00
 - i. Late Payment Fee -- 1.5 percent after 15 days

The above charges shall be reviewed annually by Staff and adjusted if necessary.

6. Once the CC&N is granted, the utility shall be required to file a rate case no later than 120 days after the fifth anniversary of serving its first customer.

ATTACHMENT B

Proposed Policy for Class D and E Water System Acquisitions

The purpose of the acquisition policy is to try to encourage acquisition and consolidation of small water utilities operating in the state. For purposes of this policy, small water utilities are limited to Class D and E water utilities, i.e., less than \$250,000 of operating revenue in the most recent calendar year. Acquisition of small water utilities should result in improved water quality and/or service for the customers.

Decision No. 62993, dated November 3, 2000, established six general conditions a water company must meet to qualify for an acquisition adjustment or rate of return premium. Per that Decision, the acquisition incentive may be granted in one of two ways: (1) recovery of an amount paid in excess of the book value of the acquired company's assets (acquisition adjustment), or (2) a rate of return premium, but not both. This policy develops criteria and procedures for determining the amount of acquisition incentive that will be eligible for recovery in rates following acquisition of a small water utility.

The purchase price for a small water utility could exceed the book value of its plant in service, resulting in a positive acquisition adjustment. This policy applies exclusively to positive acquisition adjustments, and negative acquisition adjustments shall not be recognized for rate-making purposes.

In certain cases, a rate of return premium may be allowed instead of an acquisition adjustment. Once the rate of return percentage is determined, a premium amount will increase that percentage. The premium percentage will be allowed in rates for a period of time that the Commission determines is appropriate to provide an acquisition incentive.

Following is the list of six conditions a company must prove by a preponderance of the evidence in order to obtain an acquisition adjustment or rate of return premium in rates, as well as criteria to meet those conditions.

1. THE ACQUIRED COMPANY IS A CLASS D OR E.

- This policy is to be applied to the acquisition of Class D and E water utilities, i.e., those having less than \$250,000 of operating revenue in the most recent calendar year.

2. THE ACQUISITION WILL NOT NEGATIVELY AFFECT THE VIABILITY OF THE ACQUIRER.

- The acquiring company shall provide documentation that satisfactorily demonstrates its continued financial viability subsequent to the acquisition. Staff will not recommend approval of a proposed acquisition that would be potentially detrimental to an acquirer's financial viability.

3. THE ACQUIRED SYSTEM'S CUSTOMERS WILL RECEIVE IMPROVED SERVICE IN A REASONABLE TIMEFRAME.

- The acquiring company shall submit a plan for improving service to the customers of the acquired system. The plan shall include, but not be limited to, a detailed listing of the current violations and deficiencies of the water company to be acquired, as well as the acquirer's proposed solutions and the related costs. Additionally, the plan must also include a proposal for how the rates of the small water utility's customers will be affected. The acquirer's plan should also provide estimated implementation dates for each system or service improvement. A service improvement plan might include, but is not limited to, the following:
 - a. Delivering water to customers that meets the quality standards of the Arizona Department of Environmental Quality ("ADEQ") and the Safe Drinking Water Act.
 - b. Satisfactory resolution of outstanding violations with ADEQ and the Arizona Department of Water Resources ("ADWR").
 - c. Developing a reliable source of water supply.
 - d. Developing appropriate water storage capacity.
 - e. Improved water pressure, either higher or lower, within the distribution system.
 - f. Replacement of inadequate, insufficient, deteriorated, and/or inefficient infrastructure.
 - g. Improving billing procedures, customer complaint resolution, and service response times.

4. THE PURCHASE PRICE IS FAIR AND REASONABLE (EVEN THOUGH THAT PRICE MAY BE MORE THAN THE ORIGINAL COST LESS DEPRECIATION BOOK VALUE) AND CONDUCTED THROUGH AN ARM'S LENGTH NEGOTIATION.

- One factor that would contribute to recommending an acquisition incentive is if the net plant value is either very small or zero, due to substantially or fully depreciated assets that require replacement. Although the water company assets may reflect zero net book value on the records, the assets in theory still have value due to the fact that they generate a future revenue stream. To determine if the purchase price and resulting acquisition incentive amount is fair and reasonable, Staff's evaluation shall include, but not be limited to, the following criteria:
 - a. The purchase price must be the result of good faith negotiations between the two transacting entities.
 - b. The acquisition must be conducted through an arm's length transaction, and the two parties must not be affiliates as defined by A.A.C. R14-2-801.1.
 - c. Present value of future cash flows.

5. THE RECOVERY PERIOD FOR THE ACQUISITION ADJUSTMENT SHOULD BE FOR A SPECIFIC MINIMUM TIME.

- Staff will evaluate the acquisition adjustment recovery period to be fair and reasonable to both the acquirer, and the customers of the small water utility. The specific recovery period shall be set on a case-by-case basis and shall be consistent with the period over which customers are expected to benefit, as well as mitigate the impact of cost recovery on rates.
- If a rate of return premium is sought by the acquiring company, Staff will determine the premium percentage and recovery period on a case-by-case basis. Recovery via the rate of return premium will be calculated to recoup only the excess of the purchase price over the book value of the plant in service.

6. THE ACQUISITION IS IN THE PUBLIC INTEREST

Staff will investigate the acquirer's compliance history with the ADEQ and the ADWR to determine if it is a fit and proper entity to acquire a small water utility. Acquisition incentives will not be granted to entities that are currently in violation of rules set forth by ADEQ and/or ADWR.

The acquisition of a small water utility would comply with the standard of public interest if the above detailed five conditions are met, and no ADEQ and/or ADWR rule violations are pending. Additionally, the following circumstances may further demonstrate how an acquisition could be in the public interest:

- The small water utility is insolvent, defined as “unable or having ceased to pay debts as they fall due in the usual course of business”.
- The small water utility will have increased opportunities to obtain short-term financing as a result of the acquisition. This will enable the company to make improvements to, and correct deficiencies within its water system that would enable it to serve water that meets the quality standards set forth in the Safe Drinking Water Act.
- Short-term and long-term cost savings can be demonstrated as a result of the acquisition, as well as efficiencies and economies of scale.
- As a result of the acquisition, delinquent remittance of transaction privilege tax and/or property tax by the small water utility to the Arizona Department of Revenue will be satisfied.

PROPOSED PROCEDURE

Once the two entities enter into a transfer/purchase agreement, they will submit a joint application to the Commission pursuant to Arizona Administrative Code Section R14-2-103. The joint application should include the following information:

- a) A Commission approved rate application for water companies with annual gross operating revenues of less than \$250,000 for the small water utility to be acquired as of the most recent fiscal year end, or all the information required in such a rate case application along with a request for a Commission accounting order delineating how the acquisition incentive will be treated.
- b) Financial statements of the acquirer as of the most recent fiscal year end.
- c) Disclosure of transaction as either an asset purchase and Certificate of Convenience and Necessity transfer, or stock purchase.
- d) A copy of the purchase agreement/sale document including the proposed purchase price.
- e) A detailed explanation and supporting evidence to demonstrate how the acquisition meets the six conditions to be eligible for recovery of an acquisition adjustment in rates.
- f) A list and explanation of current known deficiencies of the system to be acquired as well as the acquirer's proposed solutions to remedy the deficiencies, along with the costs, and timeframe for implementing the solutions.
- g) Reconstruction Cost New (RCN) for the small water utility to be acquired or adequate information for an RCN study to be performed.
- h) A detailed calculation of the proposed acquisition adjustment requested to be eligible for recovery in rates, a proposal for its method of recovery, and a calculation of its effect on rates.

Upon submission of the application, Staff will analyze the documentation to determine whether the acquisition meets the six conditions identified in Decision No. 62993, by:

- 1. Analyzing the company's financial information to determine that it is a Class D or E water utility.
- 2. Assessing the acquiring entity's financial resources to determine if sufficient financial resources are available to acquire a small water utility without jeopardizing the acquirer's good financial standing.
- 3. Evaluating the acquirer's proposed actions to assess whether customers of the acquired small water utility will receive improved service within a reasonable timeframe.

4. Evaluating the original cost of the existing plant assets on the acquired utility's books, as well as RCN amounts. Staff will then compare those two amounts with the proposed purchase price to determine if the purchase price is fair and reasonable; if the purchase price was negotiated, and if the sale will be conducted, through an arms length transaction; and what amount of acquisition adjustment or rate of return premium, if any, will be allowed.
5. Classifying the acquisition incentive as either a regulatory asset (acquisition adjustment) or a rate of return premium, to be recovered over a specific time.
6. Reviewing the documentation provided in response to the five conditions set forth, as well as other potential benefits identified by the acquirer and determine if the acquisition meets the criteria of public interest. Staff will also evaluate whether the acquirer is a "fit and proper" entity to purchase a small water utility.
7. Requesting and analyzing other information/data that Staff and/or the Commission deems necessary for a particular case.

ATTACHMENT C

Proposed Policy For Water System Tiered Rate Design

Pricing/rate design is the Commission's primary means of encouraging conservation. The Commission can do this by implementing inverted block rates, i.e., tiered rates. Tiered rates may not be appropriate in all circumstances. Staff will consider the appropriateness of an inverted three-tiered commodity rate structure for all water company rate cases, and if appropriate, will recommend such a tiered rate structure to encourage conservation. The tiers should be designed in a manner that customers who conserve will recognize cost savings, while high water users will pay a greater portion of the costs that increased usage places on the water system. Criteria for evaluating the appropriateness and/or type of tiered rate structure on a case-by-case basis shall include, but not be limited to, the following:

1. Number of service connections on the system.
2. Number of high usage customers on the system.
3. Gallons of average water usage per connection per month.
4. Gallons of median water usage per connection per month.
5. Source of supply.

ATTACHMENT D

Proposed Policy For Central Arizona Project (CAP) Cost Recovery

The consensus of the CAP Working Group is that the Arizona Corporation Commission (Commission) should encourage water companies to retain their Central Arizona Project (CAP) water allocation. The purpose is to allow water companies to accomplish long term planning of their water resource needs for the benefit of their customers. The consensus of the group was that the Commission should accomplish this encouragement as follows:

1. A water company would be allowed to recover CAP costs if it could demonstrate that it needed the CAP allocation to properly serve its customers.
2. The water company must demonstrate that the need would occur by the year 2025.
3. The water company must demonstrate that it will actually be using a reasonable amount of its CAP allocation by 2025.
4. The water company must demonstrate that it will be using all of its CAP allocation by 2034.
5. "Use" will be those methods of using CAP water that are defined as "use" by the Arizona Department of Water Resources.
6. In order to obtain cost recovery, a water company must file a rate case and provide evidence demonstrating items 1 through 4 above.
7. At the time that cost recovery is approved for a water company, cost recovery will depend on how much of company's CAP allocation is actually being used –
 - a. If none of the CAP allocation is actually being used, the company will be allowed to recover dollar for dollar its appropriate CAP expenses, without earning a rate of return. The cost recovery will be split between a charge in the commodity portion of the rate and a CAP Hook-up Fee. The charge in the commodity will be that amount needed to pay the M&I portion of the expense for that amount of CAP water equal to the amount of groundwater actually being used by the current customers. The CAP Hook-up Fee will be calculated as that portion needed to pay the remainder of the M&I charges. This is similar to the method used in the Vail Water Company rate case (Decision No. 62450). If the CAP Hook-up Fee is determined by the Commission to have to be excessive in order to recover all the CAP costs, the

remainder should be deferred and collected later as the company grows and adds additional customers and/or the rate of growth increases to allow the collection of additional CAP Hook-up Fees.

- b. If only a portion of the CAP allotment is being used, cost recovery will be split. For that portion of the CAP allotment not being used, cost recovery will be allowed as explained above (#7a). For that portion of the CAP allotment actually being used, cost recovery will be as with any other used and useful item in a rate case, i.e., the plant needed will be included in rate base and earn a rate of return, while the M&I and OM&R expenses for that portion of the CAP allotment will be recovered as any other expense.
 - c. When all the CAP allotment is being used, cost recovery will be as described in the second half above (#7b), i.e., just like any other plant and expense item that is used and useful.
 - d. For those water companies that have not obtained a specific accounting order from the Commission that details how CAP costs incurred up to this time would be treated and meet items 1 through 4 above, the actual amount of direct costs incurred (i.e., no rate of return or cost of money) should be recovered in rates by some method determined in a rate case, as long as such an allowance is not somehow improper (e.g., retroactive rate making, contrary to some mandatory accounting/rate making principle, etc.).
8. Within 5 years of obtaining approval for cost recovery of the CAP costs, the water company must submit a detailed engineering plan outlining how the water will be put to use.
9. If a water company that has obtained cost recovery from the Commission is not using its total CAP allotment by 2034, that portion not being used shall be sold. If a water company has recovered from ratepayers the cost for retaining that portion of the CAP allocation it sells, all net proceeds shall be refunded to ratepayers in a manner to be determined by the Commission at that time. Similarly, if a water company sells all or any portion of its CAP allocation after recovering from ratepayers the cost to retain the portion it sells, all net proceeds shall be refunded to ratepayers.